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IN THE

Supreme Court of the United States

October Term, 1971

No. 71-669

UNITED STATES STEEL CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

A. CHAUNCEY NEWLIN
Counsel for Petitioner
White & Case
14 Wall Street
New York, N.Y. 10005
(212) 732-1040

Of Counsel:
RAYMOND D. RYAN
HALIBURTON FALES, 2d
EDMUND W. PAVENSTEDT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review that part of the judgment of the Court of Appeals for the Second Circuit, entered on June 22, 1971, which relates to the "percentage depletion" issue.

Opinions and Judgment Below

With respect to this issue, the opinion of the District Court for the Southern District of New York is reported at 270 F.Supp. 253, and the opinion of the Court of Appeals for the Second Circuit is reported at 445 F.2d No. 2, p. 520, at 522-528. The opinions and the judgment below are printed in Appendix A.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered on June 22, 1971. On September 22, 1971, petitioner was granted an extension of time to November 19, 1971 for filing a petition for a writ of certiorari to review the percentage depletion issue. The jurisdiction of this Court is based on 28 U.S.C. §1254(1).

Question Presented

Whether, for Federal income tax purposes, in calculating the deduction for percentage depletion, Minnesota ad valorem and royalty taxes paid by an iron ore mining lessee are excludible from the "gross income from mining" of the lessee, and are includible in such income of the lessor, as being, within the meaning of the statute, "rents or royalties" paid by the lessee.

Statutes Involved

26 U.S.C. (1939 Internal Revenue Code) §§23(m) and 114)b)(1)(3)(4). 18 Minn. Stat. Ann., §§272, 273, 298, 299. These provisions are printed in Appendix B.

Statement

Petitioner filed an action in the United States District Court for the Southern District of New York to recover Federal income tax paid for 1950. One of the issues involved relates to the calculation of percentage depletion on

iron ore mined under leases. With respect to this issue by an agreed statement the following facts were before the Court:

In 1950 Oliver Iron Mining Company ("Oliver") was a subsidiary of petitioner and was included in a consolidated Federal income tax return filed by petitioner for that year. Oliver was both lessor and lessee of iron ore mining properties in the State of Minnesota.

All of the leases provided for the payment of royalties by the lessee, and for the payment by the lessee of all taxes levied or assessed on the leased land, on the improvements and personal property thereon, and on the iron ore.

For the year 1950, Oliver, as lessee, paid to its lessors royalties, and paid to the Minnesota taxing authorities ad valorem taxes on the leased mineral, land and improvements. It also paid to the Minnesota taxing authorities the royalty taxes due with respect to the royalties paid by it, such royalty taxes having been judicially determined to be within the covenant of the lessee to pay the taxes levied upon the leased land and the iron ore.[1]

For the year 1950, Oliver, as lessor, received royalties from its lessees, and Oliver's lessees paid to the taxing authorities ad valorem taxes on such leased mineral, land and improvements. Oliver's lessees also paid to the Minnesota taxing authorities the royalty taxes due with respect to the royalties received by Oliver under the Minnesota leases.

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1. *Marble* v. *Oliver Iron Mining Company*, 172 Minn. 263, 215 N.W. 71, 72 (1927).

With respect to a number of the properties operating in 1950 which Oliver leased from or to others, for Federal income tax purposes it calculated its deductions for depletion, not on the basis of cost, but, because it resulted in larger deductions, on the basis of 15% of the "gross income from mining" as permitted by the statute.

In accordance with the statute, in calculating for this purpose its "gross income from mining" of a particular property, Oliver excluded an amount equal to royalties paid or incurred by it in respect of the property.

Upon audit of Oliver's Federal income tax return for 1950, the Internal Revenue Service, for the first time, and without any change in the longstanding applicable statute and Regulations, in cases where Oliver was the lessee, reduced its percentage depletion deductions by excluding from its "gross income from mining" not only the royalties paid by Oliver but also the Minnesota ad valorem and royalty taxes paid by Oliver, on the theory that such tax payments constituted the payment by Oliver to the lessors of additional "rents or royalties," within the meaning of the statute.

And, in those cases where Oliver was the lessor, the Internal Revenue correspondingly *increased* its depletion deductions on account of tax payments made by its lessees.

The decreases exceeded the increases by $304,323.54. This accounted for additional Federal income tax of $179,-

926.08. Such additional tax was paid, with interest of $153,528.71. Recovery is sought of the amounts paid.

The royalty taxes paid by Oliver to the State of Minnesota were calculated on the basis of royalties paid *as such*. In administering the Minnesota royalty tax, the Minnesota tax authorities do not consider that payment by a lessee of ad valorem taxes on the property or royalty tax constitutes payment of royalty subject to royalty tax.

It is sometimes assumed that agreement by the lessee to pay all taxes in respect of a mining property virtually guarantees that the property will be mined. The record in this case includes a list of Minnesota iron ore mining leases under which Oliver was lessee or lessor which were surrendered or expired without any ore being mined, and showing the amounts of ad valorem taxes, minimum royalties, and (on such minimum royalties) royalty taxes paid by the respective lessees under such leases while they were in effect. The record also contains a list of other Minnesota iron ore leased properties, where Oliver was neither lessee nor lessor, the leases on which were surrendered without any production.

Reasons for Granting the Writ

I

Only a decision of the Supreme Court can settle the question.

This is a dispute between taxpayers, mining lessees on the one hand, and mining lessors on the other. What is good, taxwise, for one by the same token is bad for the other.

Since no lower court decision is binding in another judicial jurisdiction, unless and until there is a decision of the United States Supreme Court the litigation on the question, which now has been going on for many years,[2] may continue for a long time.

In its last ruling on the question, Rev.Rul. 64-91-1964-1 C.B. (Part 1) 219, the Internal Revenue Service announced the following policy:

> "Lessors and lessees are known to be taking opposite positions as to whether a lessee's undertaking to pay ad valorem taxes under the type of lease here in question represents a part of the arrangement between the parties for the sharing of gross income for production. Under the circumstances, pending judicial clarification of the controlling criteria the Service has no alternative but to continue to litigate what is essentially an issue between the two parties to such a lease."

After forthrightly expressing considerable uncertainty about the correct answer, the court below concluded:

> "Under the circumstances we think it best to follow the uniform line of authority and leave correction, if that is called for, to the Supreme Court or, for the future, to Congress."

Being of the nature it is, the problem is not easily subject to resolution by legislation, and, as the court below observed, legislation could only be prospective in effect.

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2. *Burt* v. *United States,* 170 F.Supp. 953 (Ct.Cl.) was decided in 1959. Rev.Rul. 16, which that decision rejected, was issued in 1953. The controversy began several years earlier. Thus, it may be said the issue has been in dispute for at least twenty years.

We submit this Court, which is the only court that can do so, would serve a useful purpose by bringing the controversy to a conclusion.

II

The decision below can lead to lack of uniformity in the application of the Federal tax law in question.

This Court has held that, in the absence of contrary Congressional intent, the Federal income tax law should be "interpreted so as to give a uniform application to a nation-wide scheme of taxation." *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932).

The rationale of the decisions upholding the position of lessors on the question at issue is that in Minnesota ad valorem taxes are imposed on the interest of the lessor as the owner of the property,[3] and, therefore, the case comes within the rule of *United States* v. *Boston and Maine R.R. Co.*, 279 U.S. 732 (1929), holding that taxes paid by a tenant on business property constitute additional rent to the landlord. However, other states, including Pennsylvania,[4] Ohio[5] and Kentucky,[6] recognize that a mining lease is basically different from a lease of space, and, for local law purposes, consider that a mining lease transfers "title" to the ore to the lessee. Thus, in such "title" States the

3. Relying on *State* v. *Evans*, 99 Minn. 220, 108 N.W. 958 (1906), holding that for Minnesota property law purposes a mining lease does not constitute a "sale" of any part of the land. *Cf. Fryberger* v. *Inland Steel Co.*, 174 Minn. 139, 218 N.W. 553, 554 (1928).

4. *Timlin* v. *Brown*, 158 Pa. 606, 28 Atl. 236 (1893).

5. *Edwards* v. *McClurg*, 39 Ohio St. 41 (1883).

6. *Swiss Oil Corporation* v. *Hupp*, 253 Ky. 552, 69 S.W.2d 1037 (1934).

reasoning of the lower courts, involving Minnesota leases, would not apply, and consistency of reasoning would require reaching a different conclusion. The result of different rules in different States would be in conflict with the principles laid down in *Burnet* v. *Harmel, supra.*

III

The decision below is contrary to the principles established by this Court in *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938).

Under the leases involved the lessee agreed to pay certain royalties to the lessor out of production. This left the lessee with the balance of the production, out of which to pay all expenses, including all taxes on the property, whatever they might turn out to be. The royalties received by the lessor were *net* to him. He had no obligation to pay any of the costs or any taxes necessarily incurred in the operation out of his share of the production, that is, out of the royalties he received. These were the terms the parties agreed upon for dividing the "gross income from mining."

This Court has held, in *Mountain Producers, supra,* that, in a case of this kind, the agreement of the parties controls, and should be followed without judicial interference, saying:

> "The term 'gross income from the property' means gross income from the oil and gas (*Helvering* v. *Twin Bell Syndicate, supra*) *and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned* * * *" (Emphasis added)

It appears in the record made in the Board of Tax Appeals in *Mountain Producers,* 34 B.T.A. 409, that production taxes and other taxes were among the costs of production which the Refining Company defrayed pursuant to the mining contract. It may be suggested that, even so, the present issue was not raised. If so, it was for the simple reason that all parties to the proceeding assumed that, for present purposes, there is no distinction between taxes and any other operating expenses.

IV

The decision below is in conflict with the rules laid down by this Court in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25 (1946) and *Anderson* v. *Helvering,* 310 U.S. 404 (1940).

The critical statutory provision involved is §114(b)(4), which provides that a lessee taxpayer must exclude from the "gross income from mining" on which his percentage depletion is based "an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

While the statute, in terms, does not qualify the words "rents or royalties," it always has been recognized that only rents or royalties *which are depletable income to the lessor* are to be excluded from the lessee's gross income from mining. Otherwise, part of the "income from mining" would not be counted in calculating depletion. The present Treasury Regulations (§1.613-2(c)(5)(i)) provide:

> "In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties (*which are depletable income*

to the payee) which are paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from 'gross income from the property.'" (Emphasis added)

This Regulation recognizes that some rents are not depletable income to the payee. Ordinary rents, which are payable with the passage of time and without regard to production, are in this category.

Therefore, even assuming, *arguendo*, payment by the lessee of Minnesota ad valorem taxes on mining property effects the payment of "rent" to the lessor, such "rents" are not excludible from the "gross income from mining" of the lessee unless they also constitute *depletable* income to the lessor. And they are not *depletable* income of the lessor if they are payable without regard to production.

The United States Supreme Court so held in *Burton-Sutton Oil Co.* v. *Commissioner, supra,* at 34, and in *Anderson* v. *Helvering, supra,* the Court held that, if a payment *might* be made out of other than production, it is not depletable income to the payee.

In *Anderson,* the taxpayer had acquired oil properties for a consideration, payable part cash and the balance from the proceeds of oil produced, *or from sale of the properties.* While the payments in question in fact were paid out of production, the Supreme Court held they were not depletable because they *might* have been paid other than from production.

In *Kirby Petroleum Company* v. *Commissioner,* 326 U.S. 599 (1946), the Supreme Court held that the rules laid

down in the *Anderson* case apply equally to payments under a lease.

The record in this case shows that sometimes a lessee will lease Minnesota iron ore property, hold it for many years, pay ad valorem taxes, and then, for one reason or another, surrender the lease without ever having produced a ton of ore.[7] Thus, even assuming the lessee's payment of ad valorem taxes was payment of additional "rent" to the lessor, since the taxes were payable with the passage of time, and without regard to whether or not there was any production, under the rules fixed by this Court by its decisions in *Burton-Sutton* and *Anderson*, it was not *depletable* rent, and, for this reason, it was not deductible from the "gross income from mining" of the lessee.

Respondent pressed this argument very strongly in *Handelman* v. *United States*, 357 F.2d 694 (Ct. Cl. 1966) when urging the Court of Claims to reconsider its decision in *Burt*.

V

The decision below is in conflict with the decisions of the Ninth Circuit in *Commissioner* v. *Felix Oil Co.*, 144 F.2d 276 (1944) and *United States* v. *Thomas*, 329 F.2d 119, *cert. den.* 379 U.S. 819 (1964).

In *Commissioner* v. *Felix Oil Co.*, the Ninth Circuit treated *state and county taxes* paid by a lessee as *expenses of production* and not additional income to the lessor, for purposes of dividing the "gross income from the property" between the lessor and the lessee for percentage depletion

7. See *John W. McLean*, 54 TC 569 (1970).

purposes. In rejecting the lessor's contrary contentions, the Ninth Circuit said:

> "The allowance for depletion under §114(b)(3) is an amount equal to a stated percentage of the 'gross income from the property' of the particular taxpayer (citations omitted). As we read the opinion in *Helvering* v. *Mountain Producers Corp., supra,* a contention virtually identical with that made by the taxpayer here was there rejected, the court saying (p. 382) that it was not 'at liberty to construct a theoretical gross income by recourse to the expenses of production operations'." 144 F.2d at 278.

United States v. *Thomas, supra,* involved a sublease under which an operator was to advance all operating expenses, subject to reimbursement out of the first production proceeds, and the non-operating owner of the sublease was to incur no personal liability for such expenses. That is, the taxpayer, a non-operator, had a so-called "net profits" interest. The Ninth Circuit held that the taxpayer's "gross income from the property," for percentage depletion purposes, was only the net amount received by him pursuant to his agreement with the operator. In reaching this conclusion the Court recognized that, from the standpoint of property law concepts, the legal relationship between the parties was that of co-owners of the working interest, but the Court pointed out that the United States Supreme Court had made it clear that, for present purposes, local title and property law concepts are not controlling. In *Thomas,* the Court concluded that under his agreement with the operator the non-operator's only interest was in the "net profits," that this was the measure of his share of the production, and that, therefore, he was entitled to calculate his depletion only on that amount.

Any lessor or non-operating owner who receives, as his share of production, payments—whether characterized as royalties, or a share of net profits, or some other term—out of which he has no obligation to discharge *any* of the things to be paid in connection with the mining operation, in practical effect has a "net" interest. There is no economic difference between ordinary royalties and a net profits interest. All such payments come to the recipient on a basis "net" to him, pursuant to his agreement with the lessor or the operator.

In tax matters economic realities control.[8] Applying this test *United States* v. *Thomas* is in conflict with the decision below.

To the same effect as *Thomas* is *Spalding* v. *United States*, 97 F.2d 697 (9th Cir.), *cert. denied*, 305 U.S. 644 (1938).

Conclusion

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

A. CHAUNCEY NEWLIN
Counsel for Petitioner

Of Counsel:
RAYMOND D. RYAN
HALIBURTON FALES, 2d
EDMUND W. PAVENSTEDT

November 1971

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8. *Kirby Petroleum* v. *Commissioner*, 326 U.S. 599, 603 (1946); *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 32, 33 (1946).

APPENDIX A

OPINIONS BELOW

Opinion of the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 790—September Term, 1970.

(Argued May 13, 1971 Decided June 22, 1971.)

Docket Nos. 35655 and 35788

UNITED STATES STEEL CORPORATION,
Plaintiff-Appellant,

against

UNITED STATES OF AMERICA,
Defendant-Appellee.

Before:

FRIENDLY, *Chief Judge,*
WATERMAN, *Circuit Judge,* and
ZAVATT, *District Judge.**

FRIENDLY, *Chief Judge*:

In this action in the District Court for the Southern District of New York, United States Steel Corporation sought large refunds of federal income and excess profits taxes for 1950. The issue with respect to income tax involved solely a question of law concerning the respective rights of the lessor and the lessee of Minnesota iron mines

* Of the District Court for the Eastern District of New York, sitting by designation.

to percentage depletion; it was decided adversely to U. S. Steel on the Government's motion for partial summary judgment, 270 F. Supp. 253 (1967). The other claims concerned the Korean excess profits tax for 1950; it will be as well to reserve statement of them until we have discussed the issue of percentage depletion.

I. *Percentage depletion*

The facts giving rise to this portion of the case are sufficiently stated in three paragraphs of the complaint:

> In 1950, Plaintiff was lessor and lessee of iron ore mining properties in the State of Minnesota. Pursuant to the terms of the leases, for 1950 the lessee paid Minnesota ad valorem taxes with respect to the mining properties and Minnesota royalty taxes with respect to royalties paid by the lessee.
>
> In determining the Federal income tax for 1950 which Plaintiff has paid, for purposes of §114(b)(4) and the determination of the depletion deduction allowable under §23(m), the Minnesota ad valorem taxes and the Minnesota royalty taxes have been included in the lessor's "gross income from the property," and have been excluded from the lessee's "gross income from the property."
>
> These adjustments were erroneous, and by reason thereof, in determining the Federal income tax for 1950 which Plaintiff has paid, deductions for depletion have been allowed in the amount of at least $304,323.54 less than the amount which should have been allowed.

Both sides moved for partial summary judgment on this issue; the district court granted the Government's motion, 270 F. Supp. 253 (1967).

A deduction for depletion, based broadly on "the theory that the extraction of materials gradually exhausts the

capital investment in the mineral deposit," 4 Mertens, Law of Federal Income Taxation §24.02 at p. 7 (1966 rev.), has been allowed in one form or another since the Revenue Act of 1913. *Id.* §§24.06-24.15b. The general problem of allocating the depletion deduction between lessor and lessee was first dealt with by Congress in the Revenue Act of 1918. Section 214(a)(10) of the 1918 Act, 40 Stat. 1068, provided that "[i]n the case of leases the deductions * * * shall be equitably apportioned between the lessor and lessee." See §234(a)(9), 40 Stat. 1078-79, for the identical provision with respect to the corporate income tax. Percentage depletion, i.e., depletion based on a stated percentage of "gross income from the property" (defined, insofar as here relevant, as "gross income from mining") rather than on the cost of the property, originated, but then only for oil and gas wells, in the Revenue Act of 1926, §204(c)(2), 44 Stat. 16.[1] Six years later in the Revenue Act of 1932, Congress addressed itself specifically to the problem of apportioning the depletion deduction between lessor and lessee with respect to percentage depletion. In addition to retaining the "equitable apportionment" provision, §23(l), 47 Stat. 181, Congress, in rewriting the provision for depletion of oil and gas wells with respect to a percentage of the taxpayer's gross income from the property and in extending this to coal, metal and sulphur mines, §114(b)(3) and (4), 47 Stat. 202-03, inserted the phrase:

> excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.

The statutes here relevant, §§23(m) and 114(b)(4) of the 1939 Code, do not differ in any significant way.

In a case decided in 1934 with respect to the tax years 1925, 1926 and 1927, the Supreme Court held in effect that

1. For the treatment under earlier acts, see 4 Mertens, Law of Federal Income Taxation §§24.04-24.11 (1966 rev.).

the provision of the 1932 Act for the deduction of royalties from the gross income of a lessee stated a result that would have been reached without it, since Congress could not have intended one consequence when the lessee turned over royalty oil in kind to the lessor and a different one when the lessee sold the oil and paid the lessor in cash. *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 321 (1934).[2] The decision did not speak to the question here at issue, whether the deduction from the lessee's gross income (and the inclusion in the lessor's) should comprehend the payments of taxes which the lessee had contracted to make and would otherwise have been payable by the lessor.

The Regulations under the 1939 Code said nothing about excluding from the lessee's gross income amounts it was obligated to pay as taxes. They read, as had their predecessors going back to those under the 1932 Act:[3]

> In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property."

The taxpayer asserts, and the Government has shown nothing to controvert this, that for many years the Commissioner made no attempt to require lessees to exclude from gross income taxes they were required to pay for the ac-

2. The royalties were one-quarter of the oil extracted—to be paid in cash or in kind; during the years in question the royalties were apparently paid in cash. *But see* text, *infra*. The lessee was "authorized to pay all the taxes on said lands and improvements and to deduct the lessor's share thereof from the amount of royalties which shall fall due."

3. Reg. 111, Sec. 29.23(m)-1(f); Reg. 103, Sec. 19.23(m)-1(f); Reg. 101, Art. 23(m)-1(g); Reg. 94, Art. 23(m)-1(g); Reg. 86, Art. 23(m)-1(g); Reg. 77, Art. 221(g).

count of the lessor, and lessors did not seek to include such amounts in their depletable gross income.

In the early 1950's several lessors, doubtless stimulated by the established rule that "[t]axes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter," Reg. 45, Art. 109 (1921), approved in *United States* v. *Boston & Maine R.R.*, 279 U.S. 732 (1929), began to press for the inclusion of taxes, which lessees were required to pay on the lessors' behalf, in the lessors' gross income as "rents or royalties," thus requiring, in principle at least, a corresponding exclusion of these amounts from the lessees' depletable income—since "[a]t all events [the depletion provision] must be read in the light of the requirement of apportionment of a single depletion allowance." *Helvering* v. *Twin Bell Oil Syndicate, supra*, 293 U.S. at 321. The Bureau, doubtless responding to conflicting pressures, adopted a somewhat Solomonic course, providing for the apportionment of such taxes.[4]

4. This was stated in Revenue Ruling 16, 1953-1 Cum. Bull. 173, 175-76, as follows:

> * * * in order to determine the amount of such taxes [ad valorem taxes] paid by the lessee for the account of the lessor it is necessary to ascertain the proportionate values of their respective interests in the property and to use such values as a basis for determining a ratio which is to be used to allocate the taxes between the parties. * * * The ratio may be determined by the Bureau, in case no agreement can be reached between the parties, or, if an agreement thereon is reached between the parties which is considered reasonable by the Bureau, such ratio will be accepted.
>
> * * * where ad valorem property taxes are imposed on mineral-bearing lands and the lessee pays the lessor's share of such taxes pursuant to the mineral lease on the land, such payments shall be treated as additional royalties which are excludable from the lessee's gross income and includible in the lessor's depletable gross income * * *. If there is insufficient gross income from production to cover the tax, such payments shall be treated as delay rental, a deductible expense of the lessee and nondepletable income to the lessor.

Dissatisfied with not getting the whole hog, Burt, a lessor whose lease there involved is also one of those in question in the instant case, brought the issue with respect to the Minnesota *ad valorem* and royalty taxes before the Court of Claims.[5] The court ruled unanimously in his favor, *Burt v. United States,* 170 F. Supp. 953 (1959). Speaking of the *ad valorem* tax, it reasoned:

> We are unable to escape the conclusion that under the terms of this particular lease the payment of the ad valorem taxes in the minerals in place was a part of the royalty compensation to plaintiffs. But for the provision in the lease that the mineral taxes were to be paid by the lessee, the levy would have been an in rem tax against the land itself, of which plaintiffs were the actual owners. Undoubtedly if the lessee had not agreed to pay these taxes the plaintiffs would have asked for and been entitled to a larger royalty payment in cash or in an increased percentage or payment of some kind. It seems to us, in essence, that it was a part of the total production income which the plaintiffs received and therefore they are entitled to the statutory depletion allowance on their part of the total production income which includes the ad valorem tax on the minerals as a part of the compensation, rent, or royalty.

Although unnecessary to its decision,[6] it applied the same reasoning to the royalty tax, and added:

> Of course, taxes as such are not a part of royalty production for either the lessor or the lessee. In this

5. Counsel for U. S. Steel submitted a brief as *amicus curiae.*

6. The Government had conceded that for the purpose of the action "the taxpayer is entitled to include in his gross income from the mineral property for the purposes of computing his depletion allowance his * * * share of all royalty taxes paid by his lessee." 170 F. Supp. at 955.

particular case we are not holding that as taxes they are the subject of depletion but as part payment to the less[or] of his part of the depletion allowance, it being a part of the yardstick to measure lessor's share of the income from the production of iron ore in connection with the grant or privilege to the lessee to conduct the mining operations on the property.

The same logic does not apply to the lessee's payment of the in rem taxes on the property. They are not a part of his income from the property, but are a part of the payment of the cost of securing the mining lease privilege on plaintiff's property. He may be entitled to charge it off as a part of his expense or as a part of the cost of the property, but such taxes are certainly not a part of his production income. He is entitled to a depletion allowance on his income from the production of the property but this income certainly does not include the taxes which he may have paid.

Apparently concerned with the loss of revenue threatened in suits by lessors challenging the partial or total disallowance of taxes paid by lessees as depletable gross income, although recovery against the lessee would probably be barred by limitation,[7] see 26 U.S.C. §§1311-1315, the Government sought reconsideration of *Burt*, so far as concerned the Minnesota *ad valorem* tax, in *Handelman* v. *United States*, 357 F.2d 694 (Ct. Cl. 1966).[8] Its argument was that whether or not the *ad valorem* taxes were "rents

7. The Tax Court followed *Burt* in *Winifred E. Higgins*, 33 T.C. 161 (1959), with only scant discussion. The Internal Revenue Service thereupon revoked its prior rulings and announced it was prepared to litigate the question both ways until it was decided. Rev. Rul. 64-91, 1964-1 (pt. 1) Cum. Bull. 219, 220.

8. Again, counsel for U. S. Steel submitted a brief as *amicus curiae*.

or royalties," they were not depletable gross income to the lessor since they were payable in any event regardless of production. After extensive review of the Supreme Court decisions on depletion, none of which it found to be particularly relevant, the court unanimously adhered to *Burt* with respect to any year where there was sufficient production to cover the payment of the taxes. 357 F.2d at 703.[9]

U. S. Steel's multi-pronged attack on these precedents may be reduced to three essential thrusts: that for percentage depletion purposes only royalties "as such," determined by the agreement of the parties, should be treated as the lessor's gross income from the property; that even if the lessee's assumption of the lessor's tax obligations be deemed an additional "rent or royalty" within the meaning of the depletion provisions, under Minnesota law both the royalty and *ad valorem* taxes are *in rem* and hence may not be treated as primarily the lessor's obligation; and that in any event the *ad valorem* taxes are not dependent on production and hence payment of them by the lessee can under no circumstances be considered depletable income to the lessor excludable from the lessee's share of the depletion allowance.

With respect to the first point, we, like other courts that have considered them, have not found the multitude of cases on which U. S. Steel relies to be of much assistance. Neither *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938) nor *Helvering* v. *Twin Bell Oil Syndicate, supra,* which U. S. Steel suggests to mandate the conclusion that only royalties "as such" must be excluded from the lessee's gross income from the property, is truly apposite. *Mountain Producers* dealt not with the narrow problem whether payments of taxes should be considered as added royalties,

9. Two recent decisions of the Tax Court have also sustained the Government's position here. *John W. McClean,* 54 T.C. 569 (1970); *John S. Thornton,* T.C. Mem. 1970-321, 29 CCH T.C.M. Dec. 1471 (1970).

but with a broader contention that the contractual assumption by the lessee of all the mining functions "as part of the purchase price of the oil," 303 U.S. at 380, should affect the allocation of the depletion allowance by allowing the lessor to include in its gross income from the property "the cost of production defrayed by the [lessee] under its contract." 303 U.S. at 379. When it rejected that contention and said that under the circumstances the cash payments to the lessor represented its return on the extraction of the resources, the Court was hardly meaning to lay down a general rule that only cash payments made directly to the lessor may be considered as rents or royalties. *Twin Bell,* as indicated above, likewise did not deal with the question before us; indeed it may well be that in *Twin Bell* itself, some of the payments held excludable from the lessee's gross income had been made to the tax authorities, see fn. 2, although in diminution of rather than in addition to those labeled strictly as rents and royalties.

The issue in *Callahan Mining Corp.* v. *CIR,* 428 F.2d 721 (2 Cir.), *cert. denied,* 400 U.S. 903 (1970), on which U. S. Steel also relies, was whether the lessor had an economic interest in the working interest supporting a depletion deduction based on gross income from the property or merely a net-profits, non-operating interest supporting a depletion deduction "only on the amounts he actually received as the ore is mined and sold." 428 F.2d at 725. U. S. Steel quotes this language and apparently relies on the case for the proposition that the court cannot construct a gross income based on anything other than the agreement of the parties and that the lessor is entitled to a deduction for depletion "only on the amounts he actually received." What neither party mentions, however, is that the very issue here facing us—at least insofar as the "royalties as such" argument is concerned—was determined by the Tax Court consistently with the decisions in *Burt* and *Handel-*

man, which it cited. 51 T.C. 1005, 1021-22. While there appears to have been no dispute over the question, the fact is that the lessee's payment of the portion of the tax—there an Idaho "net profits" tax—for which the lessor was liable was held to be includible in the lessor's gross income. Finally, despite appellant's attempt to depreciate its force, *Louisiana Land and Exploration Co.* v. *Donnelly,* 394 F.2d 273 (5 Cir. 1968),[10] constitutes another precedent in favor of the Government in this case. The court there upheld the claim of an oil and gas lessor for inclusion in depletable gross income of a Louisiana severance tax which the lessee had paid.

U. S. Steel next maintains that even if payment by the lessee of the lessor's taxes may in some circumstances be considered as additional "rents or royalties," *Burt* and its progeny were wrong in treating the Minnesota *ad valorem* tax as an obligation of the lessor which was discharged by the lessee, since the tax is merely *in rem* against the property, as, it asserts, is the royalty tax. *Marble* v. *Oliver Mining Co.,* 172 Minn. 263, 215 N.W. 71 (1927). While U. S. Steel appears to be correct in contending that these taxes are treated as *in rem* obligations under Minnesota law, it does not follow that the burden of paying them is not on the lessor's interest and that the assumption of this burden does not constitute additional rents or royalties within the meaning of the depletion statute. As stated by the Supreme Court of Minnesota:

> [T]he royalty tax is an imposition upon the lessor's right, title, and interest in the lands demised. * * * In the absence of [a] covenant [to pay the tax], the tax would, no doubt, have to be paid by the lessor to protect his title to the land. The intent of the lawmakers was to lay the burden of this tax upon the

10. Counsel for U. S. Steel also submitted an *amicus* brief in this case.

> interest and estate of the one who granted the permission to mine.

Marble v. *Oliver Mining Co., supra,* 172 Minn. at 266, 215 N.W. at 72. In *Fraser* v. *Vermillion Mining Co.,* 175 Minn. 305, 221 N.W. 13, 14, *appeal dismissed,* 278 U.S. 572 (1928), the same court, in speaking of the royalty tax, noted that "[t]he shifting of the burden of the tax from lessor to lessee is a matter of contract between the two. * * *" And in *State* v. *Rea,* 189 Minn. 456, 250 N.W. 41, 42 (1933), the Supreme Court of Minnesota was confronted with a case which was

> the only one that has come to our notice where the state has not collected its royalty tax from the recipient of the royalty, or from the lessee who may have stipulated to pay it as part consideration for the lease or permit under which exploring for or mining ore is done.

We have no reason to believe that the Minnesota courts would regard the agreement of the lessee to pay *ad valorem* (as distinct from royalty) taxes of the lessor as anything other than "part consideration for the lease." In any event, we think it rather fanciful to assume that in entering a lease agreement the lessee's contractual assumption of state taxes, which is obviously of value to the lessor, does not correspondingly reduce the amount of cash payments which the lessor receives from the lessee upon the extraction of the ore. Indeed, we can do little better than recite the hypothetical put by Judge Jones, speaking for the court in *Burt,* 170 F. Supp. at 959:

> The writer is familiar with one oil lease contract covering 1,000 acres, only a small part of which was believed by the parties to be an area of production. The lease contract provided that the owner, for a three-year period of production should receive only a pay-

ment of all taxes by the lessee. After three years he was to receive the payment of all taxes or ⅛ of the proceeds of the oil produced, whichever was larger.

Does anyone believe that in such a contract the lessee would be entitled to all the depletion allowance and the lessor to none; or that in the event the ⅛ royalty exceeded the amount of taxes, the owner's part of the depletion allowance should be limited to the excess of payments above the amount of taxes?

Finally, U. S. Steel's contention that the payment of *ad valorem* taxes by the lessee cannot be depletable income to the lessor since they are not dependent solely on production was dealt with at length, and, we believe, correctly, in the *Handelman* opinion so that it is unnecessary to repeat those considerations here.

If the question were arising for the first time, we should find the lessee's position somewhat more impressive, and the lessor's correspondingly less so, than the other courts that have considered the problem. One reason, not argued by U. S. Steel, is that when Congress wished to authorize a lessee to deduct sums other than rents properly so-called, it demonstrated its knowledge of how to say so. Section 23(a) of the 1932 Act, later §23(a)(1)(A) of the 1939 Code and now §162(a)(3) of the 1954 Code,[11] permitted the deduction of "rentals *or other payments required to be made as a condition to the continued use or possession*, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." (Emphasis supplied.) Cf. *Duffy* v. *Central R.R.*, 268 U.S. 55 (1925). If Congress had used the italicized words in §114(b)(4)(A) of the 1939 Code, the Government would surely be entitled to prevail; since

[11] Cf. The lineage goes back to §12(a) of the Act of 1916. 39 Stat. 767.

Congress used a narrower phrase and has allowed the variance to persist for forty years, arguably it desired "rents and royalties" to mean only payments specifically denominated as such. Although courts often indulge in such an approach to statutory interpretation, often for want of any better way to "find" an intent where probably there was none, there may be something rather irrational about it, especially in regard to revenue acts. The depletion provisions in the 1932 Act were doubtless drafted by specialists on the subject, quite without regard to the long-standing provision in the deductions section; and the spectacle of the average Congressman, or even of the knowledgeable members of the Ways and Means and Finance Committees, scrutinizing the language with the powerful magnifying glass needed to detect the different phrasing of the two sections and appreciate its possible significance is somewhat unrealistic.[12]

Again there is something essentially grotesque in the notions that a lessor's depletable interest grows as a state increases rates under existing tax laws and imposes new

12. Indeed, as the Court warned in *Mountain Producers*, "[a]nalogies sought to be drawn from other applications of the revenue acts may be delusive and lead us far from the intent of Congress * * *." 303 U.S. at 381.

While U. S. Steel also urges upon us the "well established rule that where a law has been administered in a certain way over a long period of time, during which the law has been repeatedly re-enacted, the legislative intention is deemed to be in accord with the administrative interpretation," the "rule" has been followed with less than undeviating consistency, see 1 Davis, Administrative Law Treatise §5.07 and cases cited therein (1958), and the truth of the matter, to use Justice Harlan's phrase, is that we are "left with a legislative history which, on the precise point at issue, is essentially negative, which shows with fair conclusiveness only that Congress was not squarely faced with the problem these cases present." *National Woodwork Mfr's Ass'n* v. *NLRB*, 386 U.S. 612, 649 (1967) (Memorandum of Harlan, *J.*). See H.R. Rep. No. 1492, 72nd Cong., 1st Sess. (1932), reprinted in 1939-1 Cum. Bull. (Part 2) 542; Seidman's Legislative History of Federal Income Tax Laws 1938-1861 464-67 (1938).

ones (as Minnesota did with the royalty tax here), or that it is "equitable" that a lessee, in addition to paying these heavier taxes, should suffer a loss in the proportion of the gross income on which it can take percentage depletion. We are also somewhat impressed by U.S. Steel's argument that many mineral lands in Minnesota are owned and leased by the State, that an *ad valorem* tax is nonetheless imposed, that payment of such a tax by the lessee cannot be regarded as discharging an obligation of the lessor, and that the Government's position would thus result in a lessee of state lands being able to include a larger proportion of gross income as subject to depletion than the lessee of privately owned land.[13] Yet it may be said against such arguments that the logical underpinnings of percentage depletion are so elusive—some would use a stronger adjective—that it is idle to attempt principled reasoning about its division between lessor and lessee.

Moreover, despite these considerations we are bound to agree that there is much force in the arguments in favor of the lessor, well expressed in the extracts from the *Burt* opinion we have quoted. There would seem to be little sense in a rule that would attribute different tax consequences to a situation where the lessor accepted a lower royalty and required the lessee to pay the taxes and another where the lessor insisted on a royalty higher by his estimate of what the taxes would be. The arguments here forcefully made by U. S. Steel have been considered and rejected on more than one occasion by two courts particularly expert in tax matters and by another court of appeals having much experience with oil and gas leases, as well as by the able district judge. While we are not bound by any of these decisions and would not hesitate to reject them if we were truly convinced they were in error, our

13. Perhaps, however, the state compensates for this by charging higher royalties.

beliefs simply do not rise to that height. *Burt* has been on the books for a dozen years, during which Congress has adopted a number of corrective tax measures but has not chosen to alter *Burt*. Under the circumstances we think it best to follow the uniform line of authority and leave correction, if that is called for, to the Supreme Court or, for the future, to the Congress.

* * *

The orders with respect to the depletion, coal strike, and cost-price issues are affirmed. The order granting summary judgment to the Government on the materials issue is reversed and the case remanded for further proceedings consistent with this opinion. No costs.

Appendix A—Judgment of the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-second day of June one thousand nine hundred and seventy-one.

Present:

HON. HENRY J. FRIENDLY, Chief Judge
HON. STERRY R. WATERMAN, Circuit Judge
HON. JOSEPH C. ZAVATT, District Judge

65 Civ. 3043

UNITED STATES STEEL CORPORATION,

Plaintiff-Appellant,

v.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Appeal from the United States District Court for the Southern District of New York.

Appendix A—Judgment of the Second Circuit

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk

A true copy,

A. DANIEL FUSARO
Clerk

[SEAL]

Appendix A—Opinion of Levet, D. J.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 Civil 3043

UNITED STATES STEEL CORPORATION,

Plaintiff,

against

UNITED STATES OF AMERICA,

Defendant.

Appearances:

White & Case
Attorneys for Plaintiff
14 Wall Street
New York, N.Y.
A. Chauncey Newlin,
Haliburton Fales, 2d
William L. Hearne,
Edmund W. Pavenstodt,
Of Counsel.

Robert M. Morgenthau, United States Attorney,
Southern District of New York
Attorney for Defendant
Laurence Vogel,
Samuel M. Eisenstat,
Assistant United States Attorneys,
Of Counsel.

Appendix A—Opinion of Levet, D. J.

LEVET, D. J.

United States Steel Corporation, the above-entitled plaintiff, has moved under Rule 56 of the Federal Rules of Civil Procedure for summary judgment with respect to the claim for depletion deductions set forth in paragraphs 16, 17 and 18 of its complaint and, likewise, for an order pursuant to Rule 54(b) of the Federal Rules of Civil Procedure determining that there is no just reason for delay and that an express direction for entry of final judgment thereon be made.

The defendant, United States of America, has countermoved for summary judgment in its favor on the claims asserted in the said paragraphs of the complaint.

The relevant claims in the complaint set forth in paragraphs 16, 17 and 18 are as follows:

"*Percentage Depletion*

"16. In 1950, Plaintiff was lessor and lessee of iron ore mining properties in the State of Minnesota. Pursuant to the terms of the leases, for 1950 the lessee paid Minnesota ad valorem taxes with respect to the mining properties and Minnesota royalty taxes with respect to royalties paid by the lessee.

"17. In determining the Federal income tax for 1950 which Plaintiff has paid, for purposes of §114(b)(4) and the determination of the depletion deduction allowable under §23(m), the Minnesota ad valorem taxes and the Minnesota royalty taxes have been included in the lessor's 'gross income from the property,' and have been excluded from the lessee's 'gross income from the property.'

"18. These adjustments were erroneous, and by reason thereof, in determining the Federal income tax

for 1950 which Plaintiff has paid, deductions for depletion have been allowed in the amount of at least $304,323.54 less than the amount which should have been allowed."

This is an action under Section 1346(a)(1) of Title 28 United States Code to recover federal income tax for the year 1950 and assessed interest on additional payments of such tax, which plaintiff claims were erroneously and illegally assessed and collected.

FACTS

During the year 1950, Oliver Iron Mining Company (hereinafter "Oliver"), a subsidiary corporation of the plaintiff, was lessee or successor lessee of certain iron ore mining properties in the State of Minnesota in that part of the state known as the Mesabi Range. (¶9, Joint Rule 9(g) Statement) All the leases of Oliver provided for the payment of royalties by the lessee and for the payment by the lessee of all taxes levied or assessed on the leased land, on the improvements and personal property thereon, and on the iron ore. (¶12, Joint Rule 9(g) Statement)

For the year 1950, Oliver, as lessee, paid to its lessors royalties, and paid to the Minnesota taxing authorities ad valorem taxes on the leased mineral, land and improvements. It also paid to the Minnesota taxing authorities the royalty taxes due with respect to the royalties paid by it, such royalty taxes being considered to be within the covenant of the lessee to pay the taxes levied upon the leased land and the iron ore.

For the year 1950, Oliver, as lessor, received royalties from its lessees, and Oliver's lessees paid to the taxing authorities ad valorem taxes on the leased mineral, land and improvements. Oliver's lessees also paid to the Minnesota taxing authorities the royalty taxes due with respect to the royalties received by Oliver under the Minnesota leases.

For 1950, the Internal Revenue Service, in those instances where Oliver was the lessee, reduced its percentage depletion deductions by excluding from "gross income from the property" the Minnesota ad valorem and royalty taxes paid by Oliver on the theory that such tax payments constituted the payment by Oliver to the lessor of additional "rents or royalties" within the meaning of the statute.[1]

The plaintiff paid to the District Director of Lower Manhattan, New York City, additional federal income taxes for 1950 with interest. (¶4, Joint Rule 9(g) Statement) The time for assessment against plaintiff of additional federal income tax for 1950 was extended to June 30, 1966 (¶5, Joint Rule 9(g) Statement) and ultimately, on June 29, 1965, plaintiff filed a claim for refund for the federal income tax paid for 1950 and interest on the same of $30,000,000 or such greater amount as may be legally refundable, with interest. (¶6, Joint Rule 9(g) Statement) This claim was rejected on August 24, 1965. (¶8, Joint Rule 9(g) Statement) The claim for an increased deduction for depletion was a part of this refund claim.

Issue

The issue before this court on this motion for summary judgment involves the depletion deduction provided for by the Internal Revenue Code of 1939 and may be expressed as follows:

"Are ad valorem taxes and Minnesota royalty taxes, paid by a lessee under iron ore mining leases,

1. Under those cases where Oliver was the lessor, the Internal Revenue Service correspondingly increased its depletion deductions on account of tax payments made by its lessees. The decreases exceeded the increases by $304,323.54, which resulted in an additional federal income tax of $179,926.08. This additional tax was paid together with interest of $153,528.71.

includible in the 'gross income from the property' of the lessor, and excludable from the 'gross income from the property' of the lessee, in calculating the deduction for percentage depletion under Sections 23(m) and 114(b) (4) (A) of the Federal Internal Revenue Code of 1939?"

RELEVANT STATUTES

The relevant statutes from the Internal Revenue Code of 1939 are as follows:

"Sec. 23. *Deductions from gross income*

"In computing net income there shall be allowed as deductions:

* * *

"(m) *Depletion.*—In the case of mines * * * a reasonable allowance for depletion * * * according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary * * *. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

"(m) *Basis for depreciation and depletion.*—The basis upon which depletion * * * [are] to be allowed in respect of any property shall be as provided in section 114."

"Section 114. *Basis for Depreciation and Depletion*

* * *

"(b) *Basis for depletion—*

"(1) *General rule.*—The basis upon which depletion is to be allowed in respect of any property shall

be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3) and (4) of this subsection.

* * * *

"(4) *Percentage depletion for coal and metal mines and sulphur*—The allowance for depletion under section 23(m) * * * shall be—in the case of metal mines, 15 per centum, * * * of the gross income from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.* * * *" (Emphasis added.)

The Treasury Regulations for the year in question provided:

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the 'gross income from the property.'" (Reg. 111 §29.23 (m)-1(f))

The present Treasury Regulations, adopted in 1960, provide:

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties (*which are depletable income to the payee*) which are paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from 'gross income from the property.'" (Emphasis added) (§1.613-2(c) (5) (i))

Appendix A—Opinion of Levet, D. J.

THE CLAIM OF THE UNITED STATES

The United States contends that the language in the Internal Revenue Code of 1939 requires the United States Steel Corporation to deduct the Minnesota ad valorem and royalty taxes paid by it before computing its gross income from the property for percentage depletion purposes. Briefly, the defendant's contention is as follows: Plaintiff, as lessee under the lease here in question, was required, pursuant to the terms of the lease, to pay these taxes, although, in fact, as defendant claims, these were obligations of the lessor; that under the law of Minnesota and under the federal tax law these payments by the plaintiff constituted "rents and royalties" paid by the lessee for the benefit of the lessor and, therefore, were excludable from the lessee's base for depletion under Section 114(b) (4) of the Internal Revenue Code of 1939.

THE CONTENTION OF THE PLAINTIFF

The plaintiff, on the other hand, contends that the Minnesota royalty and ad valorem taxes should not be excluded from the gross income from mining of the lessee in the computation of depletion deductions by the lessee.

I.

THE NATURE OF DEPLETION AND ITS ALLOWANCE

In general, the depletion deduction allowed under the Internal Revenue laws, in determining the taxable net income from mining, represents an allowance for the reduction in the content of the reserves from which the natural resource is extracted.

Beginning with the Revenue Act of 1913, the tax laws have recognized that depletion of natural resources occurs during the extraction process, and a deduction from taxable income was allowed to the owner or operator. In the

particular instance of iron ore and other minerals, taxpayers have been permitted, since the Revenue Act of 1932, to take deductions for depletion, calculated on either costs or income from mining, whichever method results in a larger deduction. The deduction based on income from mining ("percentage depletion") is a percentage of the gross income, but not more than 50% of net. The percentage allowed depends on the mineral involved. (Section 114 of the 1939 Code, §613 of the 1954 Code) Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312, 55 S.Ct. 174, 79 L.Ed. 383 (1934) and Helvering v. Mountain Producers Corporation, 303 U.S. 376, 58 S.Ct. 623, 82 L.Ed. 907 (1938) summarize the history of percentage depletion.

In Helvering v. Mountain Producers Corp., supra, Chief Justice Hughes stated: "Congress has recognized that in fairness there should be compensation to the owner for the exhaustion of the mineral deposits in the course of production. United States v. Ludey, 274 U.S. 295, 302, [47 S.Ct. 608, 71 L.Ed. 1054]." (303 U.S. p. 381, 58 S.Ct. p. 625) See Paragon Jewel Coal Co. v. Commissioner of Internal Revenue, 380 U.S. 624, 85 S.Ct. 1207, 14 L.Ed.2d 116 (1965); Parsons v. Smith, 359 U.S. 215, 79 S.Ct. 656, 3 L.Ed.2d 747 (1959); Standard Lime and Cement Co. v. United States, 329 F.2d 939, 165 Ct.Cl. 180 (1964); United States v. Thomas, 329 F.2d 119 (9th Cir. 1964), cert. denied, 379 U.S. 819, 85 S.Ct. 39, 13 L.Ed.2d 31; Denise Coal Co. v. Commissioner of Internal Revenue, 271 F.2d 930 (3rd Cir. 1959).

One of the more recent statements of general principles relative to depletion allowances was made by Mr. Justice Clark in Paragon Jewel Coal Co. v. Commisssioner of Internal Revenue, 380 U.S. 624, 626, 85 S.Ct. 1207, 1208 (1965), when he wrote:

> "The parties agree that the principles of our opinion in Parsons v. Smith, 359 U.S. 215, 79 S.Ct. 656, 3

L.Ed.2d 747 (1959), are controlling here. There we held that the deduction is allowed in recognition of the fact that mineral deposits are wasting assets and that the deduction is intended as compensation to the owner for the part used in production; that there may be more than one depletable interest in the same coal deposit, but that the right to an allocable portion of the allowance depends on the ownership of an economic interest in the coal in place since the statute makes the deduction available only to the owner of a capital interest in such deposit; and, finally, that the legal form of such capital interest is unimportant so long as it constitutes a right with regard to the coal in place."

The deduction for depletion for income tax purposes is permitted as an act of grace in recognition of the fact that mineral deposits are wasting assets and is intended as compensation to the owners for the part used up in production. Helvering v. Bankline Oil Co., 303 U.S. 362, 58 S.Ct. 616, 82 L.Ed. 897 (1938). See also Alphonso E. Bell Corporation v. Commissioner of Internal Revenue, 145 F.2d 157 (9th Cir. 1944); Kohinoor Coal Co. v. Commissioner of Internal Revenue, 171 F.2d 880 (3rd Cir. 1948), cert. denied, 337 U.S. 924, 69 S.Ct. 1168, 93 L.Ed. 1732 (1949); Sunray Oil Co. v. Commissioner of Internal Revenue, 147 F.2d 962 (10th Cir. 1945), cert. denied, 325 U.S. 861, 65 S.Ct. 1201, 89 L.Ed. 1982; Ryan v. Alexander, 118 F.2d 744 (10th Cir. 1941), cert. denied, 314 U.S. 622, 62 S.Ct. 72, 86 L.Ed. 500; Weirton Ice & Coal Supply Co. v. Commissioner of Internal Revenue, 231 F.2d 531 (4th Cir. 1956); cases under 26 U.S.C.A. §611, note 4.

Only a taxpayer with an economic interest is entitled to the depletion. Kirby Petroleum Co. v. Commissioner of Internal Revenue, 326 U.S. 599, 603, 66 S.Ct. 409, 90 L.Ed. 343 (1946); Linehan v. Commissioner of Internal Revenue,

297 F.2d 276, 278 (1st Cir. 1961). The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place (mineral) which is necessarily reduced as the oil (mineral) is extracted. See Anderson v. Helvering, 310 U.S. 404, 407, 60 S.Ct. 952, 84 L.Ed. 1277 (1940); Kirby Petroleum Co. v. Commissioner of Internal Revenue, supra.

The allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted. Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489 (1933); United States v. Thomas, 329 F.2d 119, 129 (9th Cir. 1964), cert. denied, 379 U.S. 819, 85 S.Ct. 39, 13 L.Ed.2d 31 (1964).

Although Section 611, which contains provisions similar to those in Section 23(m) of the 1939 Code, directs that a reasonable allowance for depletion shall be made in cases of mines and that "In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee," this presupposes that deductions may be allowed in other cases and the section must be read in light of the requirement of apportionment of a single depletion allowance since two or more persons "cannot be entitled to depletion on the same income." Parsons v. Smith, 359 U.S. 215, 220, 79 S.Ct. 656, 661 (1959). *Both lessor and lessee may not have the same depletion allowance.* Denise Coal Company v. Commissioner of Internal Revenue, supra; Commissioner of Internal Revenue v. Southwest Exploration Co., 350 U.S. 308, 76 S.Ct. 395, 100 L.Ed. 347 (1956). A lessee cannot deduct depreciation on property into which none of his capital has gone or as to which he suffers no loss of invested capital. 47 C.J.S. Internal Revenue §365, p. 541 and cases cited in note 98.

The "purpose of depletion allowance is not to recompense for the cost of manufacturing and marketing of the end product but is to allow for the exhaustion of the mineral assets. * * *" Standard Lime and Cement Co. v. United States, supra, 329 F.2d at 946.

II.

BURDEN OF PROOF

We start with the basic principle that Congress has the power to tax mine owners without allowing deduction for mineral depletion. Lucky Tiger-Combination Gold Mining Co. v. Crooks, 95 F.2d 865 (8th Cir. 1938).

It follows that the taxpayer's right to a claimed deduction from taxable income for depletion of mining property must be bottomed on a clear and unambiguous provision of the Revenue Acts or of regulations promulgated under them. Mineral Mining Co. v. United States, 46 F.Supp. 503 (E.D.Wis.1942), aff'd, 143 F.2d 51 (7th Cir. 1944); Quintana Petroleum v. Commissioner of Internal Revenue, 143 F.2d 588, 591 (5th Cir. 1944).

As in any deduction claimed, the Commissioner's determination of proper depletion allowances is prima facie correct, Emerald Oil Co. v. Commissioner of Internal Revenue; 72 F.2d 681 (10th Cir. 1934), and, consequently, the burden is on the taxpayer to prove the claimed deduction for depletion. Ryan v. Alexander, 118 F.2d 744 (10th Cir. 1941), cert. denied, 314 U.S. 622, 62 S.Ct. 72, 86 L.Ed. 500; Hurley v. United States, 10 F.Supp. 365 (D.Okl.1935).

III.

THE NATURE OF RENT AND ROYALTIES

"In economics, rent is the name given to the income which the owner of a productive instrument gets by using it himself or by exacting a payment from another user." 19 Enc. Britannica, 14th Ed., p. 155.

It seems to be universally agreed by the state courts that "rent" in its legal connotations is the compensation paid by a tenant for the use of land. Crowley v. Pott's Es-

tate, 180 Minn. 234, 230 N.W. 645; Gasoff Realty Corp. v. Berger, 188 Misc. 622, 69 N.Y.S.2d 46; People ex rel. Hargrave v. Phillips, 394 Ill. 119, 67 N.E.2d 281; Automobile Supply Co. v. Scene-in-Action Corporation, 340 Ill. 196, 172 N.E. 35, 69 A.L.R. 1085; Whiting Paper Co. v. Holyoke Water Power Co., 276 Mass. 542, 177 N.E. 574; see 36A, Words & Phrases, "Rent."

The federal courts have made like rulings. United States v. Florea, 68 F.Supp. 367, 373 (D.Ore.1945); Kennedy v. Boston-Continental Nat. Bank, 11 F.Supp. 611, 618 (D.Mass.1935); In re Bonwit, Lennon & Co., 36 F.Supp. 97, 100, 101 (D.Md.1940).

Royalties payable by lessee under a mineral lease are rents. Hatch v. Morgan, 12 So.2d 476, 480 (La.App.); Timm v. Brown, 78 Cal.App.2d 609, 178 P.2d 10; State v. Royal Mineral Ass'n, 132 Minn. 232, 156 N.W. 128; Scott v. Hunt Oil Co., 152 So.2d 599, 602 (La.App.).

Royalties paid to the lessor are excluded from the gross income from production on which the lessee's depletion allowance is based because allowance or double depletion allowance would result. Sunray Oil Co. v. Commissioner of Internal Revenue, 147 F.2d 962, 965 (10th Cir. 1945), cert. denied, 325 U.S. 861, 65 S.Ct. 1201, 89 L.Ed. 1982.

Under the income tax laws, when the occupant of premises pays the owner's real estate taxes, the owner is held to be receiving "rent" to the amount of the taxes paid. Eastern Coal Corp. v. Yake, 67 F.Supp. 166 (N.D.W.Va. 1946); Miles Corporation v. Lindel, 107 F.2d 729, 731 (8th Cir. 1939). The general principle involved is that if the taxpayer procures payment directly to his creditor of money due the taxpayer, he does not escape taxation merely because he did not actively receive the money. Helvering v. Horst, 311 U.S. 112, 116, 61 S.Ct. 144, 85 L.Ed. 75, 131

A.L.R. 655 (1940). See also Commissioner of Internal Revenue v. Lester, 366 U.S. 299, 81 S.Ct. 1343, 6 L.Ed.2d 306 (1961); Commissioner of Internal Revenue v. Fender Sales Inc., 338 F.2d 924 (9th Cir. 1964); Shaw Construction Company v. Commissioner of Internal Revenue, 323 F.2d 316 (9th Cir. 1963).

"Royalty" has been defined as a payment reserved by the grantor of a patent, lease of a mine or similar right and payable proportionately to the use made of the right by the grantee. See Raynolds v. Hanna, 55 F. 783, 800 (Cir. Ct., N.D.Ohio 1893); Black's Law Dictionary, Fourth Ed., "Royalty."

IV.

The Effect of the Statutes and Regulations

We may well note at the outset that there is no provision in either Section 23 or in Section 114 of the 1939 Code that the lessor and lessee are to determine the apportionment insofar as taxation is concerned. The 1954 Code, which, it is true, is not applicable here, is similar. "Leases. —in the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee." 26 U.S.C. §611(b) (1).

But these provisions do not aid the plaintiff. The (rent and) royalties paid to the plaintiff's lessor are depletable income to the lessor, Kirby Petroleum Co. v. Commissioner of Internal Revenue, 326 U.S. 599, 66 S.Ct. 409, 90 L.Ed. 343 (1946); Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 7 L.Ed. 489 (1933) and, hence, are excludable as to the plaintiff-lessee here.

The provisions of Sections 23 and 114 of the Revenue Code of 1939, relating to deduction from value of min-

ing property for depletion in computing income, were to be read and considered together as parts of the whole. Commodore Mining Co. v. Commissioner of Internal Revenue, 111 F.2d 131 (10th Cir. 1940).

V.

Twin Bell Syndicate and Mountain Producers Corp.

Plaintiff relies heavily on two cases: Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312, 55 S.Ct. 174, 79 L.Ed. 383 (1934) and Helvering v. Mountain Producers Corp., 303 U.S. 376, 58 S.Ct. 623, 82 L.Ed. 907 (1938). (See oral argument by plaintiff, p. 9). These decisions, plaintiff asserts, stand for the proposition that "For percentage depletion purposes, gross income from mining should be divided between the lessor and the lessee in accordance with their agreement." (Plaintiff's Second Supplemental Brief, p. 1).

Plaintiff's counsel on oral argument phrased his argument, based on these cases, as follows: "We say that under the Supreme Court decisions you determine the thing on the basis of the agreement between the parties, and if the lessee agrees to make these payments, why, those things are considered to be charges to him and thereby he is not, in effect, to be paying additional amounts to the lessor." (SM 12, 13).

Apparently, plaintiff argues that Twin Bell held that "only royalties paid as such were to be taken into consideration as deductions from gross income in computing a lessee's base for depletion." From this, counsel appears to vault to a position that neither the ad valorem taxes nor the state taxes on royalties (under Minnesota statutes) are deductible. All that Twin Bell decided was, that royalties payable to the lessor were to be deducted before computing the percentage depletion allowance of the lessee.

An examination of these decisions demonstrates that neither supports the thesis for which contended. In the Twin Bell Oil Syndicate case, supra, the respondent, an assignee under an oil and gas lease, was obligated to pay royalties to the lessor. The Commissioner ruled that under Section 204(c) (2) of the Revenue Act of 1926 the deduction should be limited to 27½% of gross production less "royalties" paid. The Board of Tax Appeals sustained the ruling, 26 B.T.A. 172. The Circuit Court of Appeals reversed the Board, Twin Bell Oil Syndicate v. Helvering, 9 Cir., 70 F.2d 402. The United States Supreme Court reversed.

The Twin Bell lease, it is true, provided, among other things:

> "* * * The Lessee is hereby authorized to pay all the taxes on said land and improvements and to deduct the Lessor's share thereof from the amount of royalties which shall fall due." (See Appeal Record, p. 91)

However, an examination of the decisional rulings reveals that no issue was raised at any time as to deductibility of any items equivalent to the Minnesota ad valorem tax or tax on royalties.

After discussing in Twin Bell some of the historical background of the problem, Mr. Justice Roberts wrote in part:

> "At all events, as the section must be read in the light of the requirements of apportionment of a single depletion allowance, we are unable to say that the Commissioner erred in holding that for the purpose of computation 'gross income from the property' meant gross income from production less the amounts which the taxpayer was obliged to pay as royalties. The apportionment gives respondent 27½ per cent. of the gross income from production which it had the right to retain and the assignor and lessor respectively 27½

per cent. of the royalties they receive. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance. Compare Palmer v. Bender, 287 U.S. 551, 558 [53 S.Ct. 225, 77 L.Ed. 489]." (293 U.S. p. 321, 55 S.Ct. p. 178)

When Twin Bell was decided by the Ninth Circuit (70 F.2d 402) headnote 4 was as follows:

"Rentals and royalties, paid by assignee of oil lease, *held* part of its gross income, and hence not deductible therefrom in computing depletion allowance for purpose of determining its net taxable income (Revenue Act 1926, §204(c) (1, 2), 213(a), 232, 233(a), 234(a) (1), (8), 26 U.S.C.A. §§935(c) (1,2), 954(a), 984, 985(a), 986(a) (1) (8); Revenue Act 1932, §114(b) (3), 26 U.S.C.A. §3114(b)."

The United States Supreme Court reversed this decision and held that "royalties" were deductible—making no mention of "rents" or of "taxes" of the lessor payable to the lessee.

Moreover, I find nothing in the present case to bind the Commissioner to accept whatever the lessor and lessee have agreed as to apportionment. Obviously, the lease determines the obligations of the lessee to the lessor. However, as repeatedly stated in tax decisions, the issues must be determined by realities. United States v. Thomas, 329 F.2d 119 (9th Cir. 1964), cert. denied, 379 U.S. 819, 85 S.Ct. 39, 13 L.Ed.2d 31. It is the function of the Commissioner and not that of lessors and their lessees to determine apportionment in the first instance.

I fail to find any support for plaintiff in Twin Bell and I find nothing in Mountain Producers Corp. which is applicable to the issues of the present case.

VI.

Minnesota Statutes and Their Effects

The Minnesota Ad Valorem Property Tax

The Minnesota law prescribes a tax on all real and personal property in the state. Minn.Stat. §272.01. "The taxes assessed upon real property shall be a perpetual lien thereon * * *," see Minn.Stat §272.31, and if such taxes are not paid the property is sold to satisfy the tax lien. Minn.Stat. §272.39.

Under Minnesota law it is clear that the lessor, and not the lessee, is the owner of the property. State v. Evans, 99 Minn. 220, 108 N.W. 958 (1906). The Supreme Court of Minnesota has held that monies received under the conventional mining lease, such as that involved here, are rent rather than proceeds of the sale of the property. State ex rel. Inter-State Iron Co. v. Armson, 166 Minn. 230, 207 N.W. 727 (1926).

Moreover, the Minnesota Supreme Court, in a case involving the question as to whether or not the lessor could avoid the payment of the ad valorem property taxes on a theory that the lessee in effect paid all the ad valorem taxes due on the property when the lessee paid the gross earnings tax, held that the lessor was still liable for the ad valorem property tax. State v. Fawkes, 210 Minn. 587, 299 N.W. 666 (1941). In that case the court wrote in part:

> "* * * The defendant [lessor] still has his property in the real estate here involved, and it earns him a substantial return. The express company [lessee] has only a leasehold interest in the property." 299 N.W. at 667.

This principle has also been upheld in interpreting federal law. See Von Baumbach v. Sargent Land Co., 242

U.S. 503, 511, 37 S.Ct. 201, 61 L.Ed. 460 (1971); Burt v. United States, 170 F.Supp. 953, 145 Ct.Cl. 282 (1959); Handelman v. United States, 357 F.2d 694 (Ct.Cl. 1966).

MINNESOTA TAXES ON ROYALTIES

Minnesota statutes provide for a tax on all royalty received during each year for permission to explore, mine and remove ore. Minn.Stat. §299.01.

Minnesota decisions have distinctly enunciated the principle that the royalty tax is a tax on the ore lands of the owner. Marble v. Oliver Mining Co., 172 Minn. 263, 215 N.W. 71 (1927). There, the Minnesota Supreme Court stated as follows:

> "* * * We conclude the royalty tax to be a tax on the right, title, and interest in ore lands of the *owner* thereof who has granted another the right to mine the ore for a stipulated consideration, payable at certain times during a period of years.
>
> "* * * In the absence of the covenant, the tax would, no doubt, have to be paid by the lessor to protect his title to the land. The intent of the lawmakers was to lay the burden of this tax upon the interest and estate of the one who granted permissions to mine. (Emphasis added) 215 N.W. at 71-72.

See also Lake Superior Consolidated Iron Mines v. Lord, 271 U.S. 577, 46 S.Ct. 627, 70 L.Ed. 1093 (1925); Burt v. United States, 170 F.Supp. 953, 145 Ct.Cl. 282 (1959).

The United States Court of Claims in 1959 decided that the payment of ad valorem taxes under a similar lease was a part of the royalty compensation to the lessor and that taxes on royalties of lessor, although paid by lessee pursuant to the terms of the lease, constituted additional rent to the lessor. Burt v. United States, supra.

The Tax Court followed the Burt case in Winifred E. Higgins, 33 T.C. 161 (1959). In that case, Higgins was a lessor of United States Steel Corporation. Judge Fisher wrote:

> "The only issue presented is whether ad valorem real estate taxes paid by lessee, United States Steel Corporation, on an iron ore mine are includible in lessor's gross income for such years as additional rent or royalty and thus part of lessor's gross income from the property.
>
> * * *
>
> "Both parties agree that Burt v. United States, 170 F.Supp. 953 [145 Ct.Cl. 282] (1959), decided adversely to the United States, is 'on all fours' with the instant case. Respondent would have us hold that the Court of Claims was in error. We have carefully reviewed Burt v. United States, supra, in the light of the arguments presented by respondent in the instant case. We agree with the reasoning of the Court of Claims in the Burt case, as well as the conclusion reached by that court. We, accordingly, sustain petitioner's position in the instant case." (p. 161)

In 1967, the Court of Claims adhered to the Burt decision in holding that payment of Minnesota ad valorem taxes paid by a lessee for a lessor constituted additional rent. Handelman v. United States, 357 F.2d 694 (Ct.Cl.1966). It is also interesting to note that present counsel for plaintiff filed briefs in both the Burt and Handelman cases for United States Steel Corporation as amicus curiae.

The Minnesota determinations are, therefore, not provincial in character but, in fact, are approved by the federal courts.

I agree with the results reached in the above-mentioned cases. From these authorities and from the nature of the

taxes I am forced to conclude that the plaintiff, in paying the ad valorem taxes and taxes on royalties was, in fact, defraying an obligation of the lessor and, hence, these taxes were a part of the rent or royalties and, consequently, deductible from the base for computation of depletion by lessee.

VII.

The Depletable Nature of the Payments

The nature of the royalty tax (Minn.Stat. §299.01) is such that it is clear that it is directly related to production and, hence, is depletable income to the lessor. The plaintiff's argument that, in any event, the payment of ad valorem taxes by the lessee was not depletable income to the lessor must be rejected.

In both Burt v. United States, 170 F.Supp. 953, 145 Ct. Cl. 282 (1959), and Handelman v. United States, 357 F.2d 694 (Ct.Cl.1966), the government unsucessfully put forth the argument that the lessor may not include in its base for depletion the ad valorem taxes paid by the lessee.

The Court of Claims in Handelman, in rejecting the argument that the ad valorem taxes were not dependent on production, wrote:

> "The single purpose of the lease, of course, is for production of the ore, and the lessee would hardly subject himself to contractual liability for the ad valorem taxes without a very definite prospect of producing the ore. * * * It would be unreasonable to assume that the lessor would continue to get the benefits of these payments over a very long period of time in the absence of any prospect of production out of which the lessee could retrieve his payment. * * * Little business acumen is needed to know that when it appears that further production will not be adequate to cover direct operating expenses and the ad valorem taxes, the lessee will

terminate the lease and the obligation for the taxes will revert to the lessor. The conclusion is that the payment of these taxes is sufficiently related to production as to be dependent upon it." 357 F.2d at 703.

The plaintiff maintains that the ad valorem taxes are not directly related to production, since these taxes accrue with the passage of time. In considering the same point in Handelman, the court stated:

"In reply, the Government argues that while payment of taxes may in fact come from production, there is a possibility that they will be paid when there is no production, and, therefore, payment is not dependent solely on production. Undoubtedly that possibility exists, but, as has been shown, it is inconsistent with economic reality. Without production, payment in most instances would be quickly curtailed." 357 F.2d at 703.

The court went on to say:

"There is no apparent reason why the ad valorem tax payments cannot be fragmented into annual units to determine whether each is production income or in the nature of a delay-rent. There is no present necessity for determining whether amounts to be received a half century from now will come from production or not. It will be known, when each annual tax report is filed, whether there was sufficient production to cover the payment of the taxes. It is agreed that simplicity in the application of the depletion provisions is desirable but, whenever possible, the court should avoid arriving at unrealistic results in the name of simplicity. The Government itself has chosen the 12-month year as the taxpaying unit. It should, in turn, allow the taxpayer to use a similar unit to determine if he has, in fact, suffered any depletion of his resources." 357 F.2d at 703.

The plaintiff emphasizes that its mining leases have, on occasion, been surrendered without any production, and it cites nine examples. (Ex. F. to Joint Rule 9(g) Statement) Yet, the lease figures supplied by the plaintiff indicate that surrender of a lease without production is an unusual situation. (Compare Ex. F. to Joint Rule 9(g) Statement with letter from plaintiff's counsel attached to defendant's Reply Memorandum of Law) But surely our tax laws must be interpreted with a view to prevailing economic realities, not to unique situations.

I conclude that the ad valorem taxes paid by the lessee on behalf of the lessor were related to production and are includible by the lessor in its base for depletion.

CONCLUSION

Thus, it is clear that the following principles apply here: (1) Depletion allowances are an act of grace; (2) The depletion allowance must be based upon statutes; (3) The burden is on the taxpayer to show that his depletion claim is within the statutory provision; (4) The determination of the Commissioner is prima facie correct; (5) Only a taxpayer with an economic interest is entitled to this depletion; (6) Both lessor and lessee may not have the same depletion allowance; (7) Minnesota ad valorem and state royalty taxes paid by the lessee for the lessor are rents and royalties which the lessor was obligated to pay and, hence, are deductible from the base of the lessee's depletion allowance.

Consequently, plaintiff's motion for summary judgment is denied and defendant's motion for summary judgment is granted. No genuine issue as to any material facts exist and the defendant is entitled to judgment as a matter of law.

There is no just reason for delay and I direct that final judgment on this claim be entered.

Settle judgment on notice.

Federal Internal Revenue Code of 1939

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance

shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(4) *Percentage depletion for coal and metal mines and for certain other mines and natural mineral deposits.*—

(A) In general.—The allowance for depletion under section 23(m) in the case of the following mines and other natural deposits shall be—

* * *

(iii) in the case of metal mines, * * * 15 per centum, * * *

of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(B) Definition of gross income from property.—As used in this paragraph the term "gross income from the property" means the gross income from mining. * * *

Minnesota Statutes

(18 Minn. Stat. Ann. includes §§270-284; 19A includes §§291-299).

§272.01 *Property subject to taxation.*

All real and personal property in this state, and all personal property of persons residing therein, including the property of corporations, banks, banking companies, and bankers, is taxable, except such as is by law exempt from taxation.

§272.04 *Mineral, gas, coal, and oil owned apart from land.*

When any mineral, gas, coal, oil, or other similar interests in real estate are owned separately and apart from and independently of the rights and interests owned in the surface of such real estate, such mineral, gas, coal, oil, or other similar interests may be assessed and taxed separately from such surface rights and interests in such real estate and may be sold for taxes in the same manner and with the same effect as other interests in real estate are sold for taxes.

§272.31 *Lien of real estate taxes*

The taxes assessed upon real property shall be a perpetual lien thereon, and on all structures and standing timber thereon and on all minerals therein, from and including May first in the year in which they are levied, until they are paid; but, as between grantor and grantee, such lien shall not attach until the first Monday of January of the year next thereafter.

§272.38 *Structures, standing timber, or minerals not to be removed*

Subdivision 1. *Taxes to be first paid.* No structures, standing timber, minerals, sand, gravel, peat, subsoil, or topsoil shall be removed from any tract of land until all the taxes assessed against such tract and due and payable shall have been fully paid and discharged. When the state auditor or the county auditor has reason to believe that any such structure, timber, minerals, sand, gravel, peat, subsoil, or topsoil will be removed from such tract before such taxes shall have been paid, either may direct the county attorney to bring suit in the name of the state to enjoin any and all persons from removing such structure, timber, minerals, sand, gravel, peat, subsoil, or topsoil therefrom until such taxes are paid. No bond shall be required of plaintiff in such suit.

§273.19 *Lessees and equitable owners*

Property held under a lease for a term of three or more years, or under a contract for the purchase thereof, when the property belongs to the state, or to any religious, scientific or benevolent society or institution, incorporated or unincorporated, or to any railroad company or other corporation whose property is not taxed in the same manner as other property, or when the property is school or other state lands, shall be considered, for all purposes of taxation, as the property of the person holding the same.

§298.01 *Mining or producing ores*

Subdivision 1. Every person engaged in the business of mining or producing iron ore or other ores in this state shall pay to the State of Minnesota an occupation tax equal to 11 percent for the year 1947, and for each year thereafter of the valuation of all ores mined or produced. Said tax shall be in addition to all other taxes provided for by law

and shall be due and payable from such person on May 1 of the year next succeeding the calendar year covered by the report thereon to be filed as hereinafter provided.

Subd. 2. There is hereby imposed an additional tax on all persons and companies engaged in the business of producing or mining iron ore or other ores equal to one per cent of the valuation of all ores mined or produced to be assessed, paid and collected as a part of the occupation tax levied by subdivision 1.

§298.03 *Value of ore; how ascertained*

The valuation of iron or other ores for the purposes of determining the amount of tax to be paid under the provisions of section 298.01 shall be ascertained by subtracting from the value of such ore, at the place where the same is brought to the surface of the earth, such value to be determined by the commissioner of taxation:

(1) The reasonable cost of supplies used and labor performed at the mine in separating the ore from the ore body, including hoisting, elevating, or conveying the same to the surface of the earth;

(2) If the ore is taken from an open pit mine, an amount for each ton of ore mined or produced during the year equal to the cost of removing the overburden, divided by the number of tons of ore uncovered, the number of tons of ore uncovered in each case to be determined by the commissioner of taxation;

(3) If the ore is taken from an underground mine, an amount for each ton of ore mined or produced during the year equal to the cost of sinking and constructing shafts and running drifts, divided by the number of tons of ore that can be advantageously taken out through such shafts and drifts, the number of tons of ore that can be advan-

tageously taken out in each case to be determined by the commissioner of taxation;

(4) The amount of royalties paid on the ore mined or produced during the year;

(5) A percentage of the ad valorem taxes levied for such year against the realty in which the ore is deposited equal to the percentage that the tons mined or produced during such year bears to the total tonnage in the mine;

(6) The amount or amounts of all the foregoing subtractions shall be ascertained and determined by the commissioner of taxation.

§299.01 *Tax on royalties*

Subdivision 1. There shall be levied and collected upon all royalty received during the year ending December 31, 1947, and upon all royalty received during each calendar year thereafter, for permission to explore, mine, take out and remove ore from land in this state, a tax of 11 percent.

Subd. 2. There is hereby imposed as an additional tax upon all royalty received for the permission to explore, mine, take out and remove ore from land in this state, a tax of one percent to be levied and collected as a part of the tax levied by subdivision 1.

§299.08 *Lien; payment of tax*

The situs of royalty, for all purposes of this chapter, shall be in this state; and the tax herein provided for shall be a specific lien from the time the royalty accrues upon all and singular the right, title, and interest of the person to whom such royalty is payable, in and to the land, for permission to explore, mine, take out, and remove ore on which the royalty is paid, and shall be a specific lien upon such royalties as they accrue. Every person paying royalty to another which is subject to tax hereunder, upon which the

royalty tax has not been paid, shall withhold the amount of the tax upon such royalty and remit the same to the state treasurer at the time the royalty is paid. Such payment to the state treasurer shall operate to discharge to that extent the liability of the person paying such royalty to the royalty recipient. At the time of such payment he shall file with the state treasurer and with the commissioner of taxation a report thereof on forms to be prescribed by the commissioner of taxation. If any person paying royalty to another shall fail to withhold the tax thereon or the penalty imposed by section 299.06, after notice thereof as therein provided, and pay the same to the state treasurer, he shall be liable for the amount of such tax and penalty, with interest at the rate of 12 percent per annum from the time the same should have been paid, to be recovered in an action by the attorney general for and on behalf of the state. The commissioner of taxation, may, upon petition of any royalty payor or recipient, upon such conditions as he may impose, permit the paying of the tax in one annual payment instead of as such royalty accrues, in which case such annual payment shall be made at such times as the commissioner of taxation directs, not later than June 30 of the year following the accrual of the royalty. No such extension of time shall be granted unless, as one of the conditions thereof, the royalty payor shall guarantee the payment of the tax.

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In the Supreme Court of the United States

OCTOBER TERM, 1971

UNITED STATES STEEL CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

ERWIN N. GRISWOLD,
Solicitor General,

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
GRANT W. WIPRUD,
Attorneys,
Department of Justice,
Washington, D. C. 20530.

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Statutes:

Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)):	
Sec. 23(m)	2, 3
Sec. 114(b)	2, 3

Miscellaneous:

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Treasury Regulations on Income Tax (26 C.F.R.):	
Sec. 1.612-3(a)	6
Sec. 1.612-3(b)	6

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-669

UNITED STATES STEEL CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A 18a-39a) is reported at 270 F. Supp. 253. The opinion of the court of appeals (Pet. App. A 1a-15a) is reported at 445 F. 2d 520.

JURISDICTION

The judgment of the court of appeals was entered on June 22, 1971 (Pet. App. A 16a-17a). By order dated September 22, 1971, Mr. Justice Harlan ex-

tended the time for filing a petition for a writ of certiorari to and including November 19, 1971. The petition was filed on November 18, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Whether Minnesota ad valorem and royalty taxes, paid by lessees under iron ore mining leases, were excludable from the depletion base ("gross income from the property") of the lessees, and includable in the depletion base of the lessors, in calculating percentage depletion deductions under Sections 23(m) and 114(b)(4)(A) of the Internal Revenue Code of 1939.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 are set forth in Appendix B to the petition (Pet. App. B 41a-42a).

STATEMENT

During the taxable year 1950, petitioner's subsidiary, Oliver Iron Mining Company (Oliver), was both lessor and lessee of iron ore mining properties in the State of Minnesota. All of the leases required the lessee to pay royalties, and further, to pay the Minnesota taxes on royalties and on the leased land, improvements and iron ore. For the year 1950, Oliver, as lessee, paid royalties to its lessors, and paid to Minnesota taxing authorities the local royalty taxes and the ad valorem taxes referred to immediately

above. Conversely, where Oliver was the lessor, its lessees paid royalties and the Minnesota royalty and ad valorem taxes. (R. 87a.)[1]

All of the leases under which Oliver was lessee or lessor provided for minimum annual royalties to be paid regardless of production, with the further provision that, in any year in which production exceeded the minimum tonnage, the excess royalties payable would be credited toward the minimum royalties of other years in which actual production was below that required to produce minimum royalties. Some of the leases also provided for a bonus payable by the lessee at the time the lease was signed. All of the leases were cancellable at the option of the lessee upon notice to the lessor of between six months and three years. (R. 59a, 64a.)

On audit for 1950, the Commissioner reduced Oliver's percentage depletion deductions, where it was the lessee, by excluding from its depletion base ("gross income from the property") the ad valorem and royalty taxes it had paid, on the ground that such tax payments constituted additional "rents or royalties" paid for the benefit of the lessors within the meaning of Sections 23(m) and 114(b)(4)(A) of the 1939 Internal Revenue Code. Conversely, in those cases where Oliver was the lessor, the Commissioner increased its depletion base by the amount of the tax payments made by its lessees. The decreases exceeded the increases by $304,323.54, which resulted in the

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[1] "R." references are to the separately bound Joint Appendix filed in the court of appeals.

assessment of a deficiency of $179,926.08. After payment of the tax in dispute, petitioner brought this suit for refund. (R. 87a-88a.)

The district court, ruling first that the law of Minnesota imposed the taxes involved on lessors of mineral properties, held that the payment of such taxes by a lessee constituted the constructive payment of additional "rents or royalties" which were includable in the depletion base of the lessor and, by the same token, excludable from the depletion base of the lessee. The court of appeals affirmed.

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review.

1. A uniform line of authorities is squarely in accord with the instant ruling that a lessee's payment of local taxes on a mineral property or production therefrom constitutes the constructive payment of additional royalties, includable in the depletion base of the lessor rather than the lessee, given the fact that the taxes involved would be payable by the lessor but for the lessee's undertaking to pay them under the lease. *Burt* v. *United States*, 170 F. Supp. 953 (Ct. Cl.) (Minnesota royalty and ad valorem taxes); *Higgins* v. *Commissioner*, 33 T.C. 161 (Minnesota ad valorem taxes); *Handelman* v. *United States*, 357 F. 2d 694 (Ct. Cl.) (Minnesota ad valorem taxes); *Louisiana Land and Exploration Co.* v. *Donnelly*, 394 F. 2d 273 (C.A. 5) (Louisiana severance tax); *Callahan Mining Corp.* v. *Commissioner*, 51 T.C. 1005, 1021-1022, affirmed on other grounds,

428 F. 2d 721 (C.A. 2), certiorari denied, 400 U.S. 903 (Idaho net profits tax); *McLean* v. *Commissioner*, 54 T.C. 569 (Minnesota ad valorem tax); *Thornton* v. *Commissioner*, P-H Memo T.C., par. 70,321 (Minnesota ad valorem tax).

2. The decision below and the authorities it follows are in accordance with sound principles. As this Court held in *United States* v. *Boston & M.R. Co.*, 279 U.S. 732, 734, payment by a lessee of business property of taxes on the property owed by the lessor, pursuant to the terms of the lease, is merely a "short cut" to payment of additional rentals to the lessor. In like manner, the court below explained (Pet. App. A 11a) that it is "rather fanciful to assume that in entering a lease agreement the lessee's contractual assumption of state taxes, which is obviously of value to the lessor, does not correspondingly reduce the amount of cash payments which the lessor receives from the lessee upon the extraction of the ore." In short, the payment of taxes by the lessee is in lieu of larger royalties.

It is true that the payment of taxes must be related to and dependent upon production in order to be attributable to the lessor's depletable economic interest, when paid on its behalf, and therefore includable in its depletion base. See, *e.g.*, *Palmer* v. *Bender*, 287 U.S. 551. But there is no basis for petitioner's contention (Pet. 9-11) that such dependence is lacking here. The dependence of the royalty tax on production scarcely need be labored. The ad valorem taxes on minerals are no less dependent upon production in the requisite sense. This conclusion follows as a

corollary from the settled rule that initial bonuses and advances or minimum royalties (which were provided for in the leases in question) are depletable income to the lessor, notwithstanding the fact that they are fixed amounts which may or may not be recouped by production. See, *e.g.*, *Burnet* v. *Harmel*, 287 U.S. 103; *Bankers Coal Co.* v. *Burnet*, 287 U.S. 308; *Freund* v. *United States*, 367 F. 2d 776 (C.A. 7); *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5), certiorari denied, 389 U.S. 977. Such fixed payments are depletable in the first instance, subject to restoration of the depletion deductions to income if there is no production. *Douglas* v. *Commissioner*, 322 U.S. 275; Treasury Regulations on Income Tax (1954 Code), Section 1.612-3(a)(2) and (b)(2).

Bonuses and advances or minimum royalties are so treated because they are in contemplation or anticipation of production. *Johnson* v. *Phinney*, 287 F. 2d 544, 547 (C.A. 5). The Minnesota ad valorem taxes are in the same category. The lessee undertakes to pay them only because it anticipates their recoupment from production, and will terminate payment (by availing itself of provisions for cancellation such as those in the leases here) if production is insufficient to cover its expenses. See *Handelman* v. *United States*, *supra*, 357 F. 2d at 703.[2]

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[2] In contrast, delay rentals and shut-in payments are not depletable income to the lessor because they are made only for the failure to produce, or for the privilege of not producing, and are therefore not in contemplation of production. See *Johnson* v. *Phinney*, *supra*, 287 F. 2d at 545, 547; *Sneed* v. *Commissioner*, 33 B.T.A. 478.

The cases upon which petitioner relies (Pet. 10) in this connection (*Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, and *Anderson* v. *Helvering*, 310 U.S. 404) are not to the contrary. They deal with payments—unlike those here—which are wholly unrelated to production.

3. Petitioner contends (Pet. 8-9, 11-13) that the instant decision and underlying authorities are in conflict with decisions which, it asserts, hold that a mineral lessor's depletable income is limited to the share of production expressly payable to the lessor under the lease, as royalties or otherwise. Petitioner cites *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376; *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276 (C.A. 9); *United States* v. *Thomas*, 329 F. 2d 119 (C.A. 9), certiorari denied, 379 U.S. 819; and *Spalding* v. *United States*, 97 F. 2d 697 (C.A. 9), certiorari denied, 305 U.S. 644. Its reliance on these decisions is misplaced.

In *Mountain Producers*, this Court held that the depletable income of a mineral lessor was comprised solely of the cash payments received and did not include any portion of the "expenses of production" which the lessee was obligated to bear under the terms of the lease. Petitioner contends that the taxes here were "expenses of production" and therefore, under *Mountain Producers*, not includable in the lessor's depletable income. But this argument fails to differentiate between the drilling and development expenses of production, traditionally borne by a lessee, and taxes which are primarily the obligation of the lessor. While it appears that taxes of some sort were

among the "expenses of production" involved in *Mountain Producers*, they were neither mentioned nor discussed in the Court's opinion. And, as the Court said in *Webster* v. *Fall*, 266 U.S. 507, 511, "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents."

Similarly, in *Felix Oil Co.* and *Spalding*, *supra*, while it appears from the records therein that taxes were included in the "expenses of production," there is no indication of the nature of those taxes or that the courts focused on the taxes as distinct from the other expenses. The silence of these courts on the proper allocation of taxes surely cannot be taken as approval of petitioner's position here.[3] As the Fifth Circuit explained in *Louisiana Land and Exploration Co.* v. *Donnelly*, *supra*, 394 F. 2d at 279—

> The difference between *Felix Oil Co.* and the *Burt* line of cases is that there was no question of *taxes* due by the lessor involved in *Felix Oil Co.* and it would have been improper to consider as gross income (for depletion computation purposes) production expenses *other than taxes* paid by lessee in the mining of the property, which expenditures were solely those of lessee *for which lessor had no liability.*

[3] *United States* v. *Thomas*, *supra*, is merely another factual version of *Mountain Producers*, and it does not appear from the opinion in that case that any taxes were included in the expenses of production.

Moreover, in *Callahan Mining Corp.* v. *Commissioner*, *supra*, although the lessor's depletion base was held to consist of a share of production income free of expenses of production, the Tax Court held that local taxes paid by the lessee were the primary obligation of the lessor, and hence includable in its depletion base.

4. Petitioner argues (Pet. 7-8) that the laws of various states differ from those of Minnesota in such fashion as to place the primary obligation for local taxes on the lessee, and, hence, that using the test of primary obligation derogates from nationwide uniformity in the treatment of local taxes for depletion purposes. Precisely the opposite is true. So long as taxes with a similar incidence are treated similarly for depletion purposes, the required uniformity is preserved. See *Burnet* v. *Harmel*, *supra*, 287 U.S. at 110; cf. *Poe* v. *Seaborn*, 282 U.S. 101, 110, 117-118; *Fernandez* v. *Wiener*, 326 U.S. 340, 358-359; *United States* v. *Davis*, 370 U.S. 65, 70-71; *United States* v. *Mitchell*, 403 U.S. 190, 197. And it may be noted that Minnesota is by no means alone in imposing taxes relating to mineral properties on lessors; as appears above, Louisiana and Idaho, at least, take the same approach.

5. The government is, of course, essentially a stakeholder in cases where the question is whether the lessor or the lessee shall include in its depletion base local taxes paid by the lessee. In order to avoid whipsaw, the Internal Revenue Service has ruled that it will oppose both the lessor and the lessee as litigants unless they agree upon an allocation of local

taxes between them. Rev. Rul. 64-91, 1964-1 Cum. Bull. (Part 1) 219. Since the successive decisions in favor of the lessor in *Burt*, *Higgins* and *Handelman*, however, the government has generally sided with the lessor, as in the instant case, and in *Louisiana Land and Exploration Co.* and *Callahan Mining Corp.*, *supra*. For the reasons stated above, we believe that the uniform line of authority in favor of the lessor is well grounded. At all events, given the unanimity of the authorities, there is no need for review by this Court at this time.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

GILBERT E. ANDREWS,
GRANT W. WIPRUD,
Attorneys,

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